Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2985

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From: Steve Leimberg's Estate Planning Newsletter

Subject: Martin M. Shenkman, Jonathan G. Blattmachr & Lawrence Lipoff: Levine Greenlight Certain Intergenerational Split-Dollar Life Insurance Plans - Int to the Roadmap

"A careful reading of the Levine case to identify steps the Levine Court found favorable might be used to craft a roadmap of how to implement a similar plan. Importantly, many of the points in the roadmap presented below gleaned from the Levine case should be considered by taxpayers undertaking almost any type of estate planning. While some aspects of the Levine opinion are narrowly limited to the intergenerational split-dollar insurance arrangement technique used in the case, many of the aspects may have broad applicability."

Martin M. Shenkman, **Jonathan G. Blattmachr** and **Lawrence Lipoff** provide members with their "roadmap" for implementing Intergenerational Split Dollar plans.

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Here is their commentary:

EXECUTIVE SUMMARY:

A recent Tax Court decision provided a victory to the taxpayer who had pursued what some might view as an aggressive split-dollar life insurance plan to minimize estate taxes.[i] This follows prior cases that indicated problems for other taxpayers who had implemented similar, but distinguishable, split-dollar arrangements. Understanding what the taxpayer did in the Levine case, and how that contrasts to what taxpayers did in one of the prior cases, Estate of Cahill v. Comm r, T.C. Memo 2018-84, may provide guidance to taxpayers contemplating such planning. But, in some instances, even better guidance may be possible. A careful reading of the Levine case to identify steps the Levine Court found favorable, might be used to craft a roadmap of how to implement a similar plan. Importantly, many of the points in the roadmap presented below gleaned from the Levine case should be considered by taxpayers undertaking almost any type of estate planning. While some aspects of the Levine opinion are narrowly limited to the intergenerational split-dollar insurance arrangement technique used in the case, many of the aspects may have broad applicability.

Although many view Levine as a major taxpayer victory for split-dollar, it is only one decision of the Tax Court where two prior decisions, Cahill and Morrissette, appear less favorable.[ii] And no appeals court has yet to weigh in. So, breaking out the champagne for the type of plan Mrs. Levine and her family implemented probably is a little premature. Moreover, as discussed at the end of this newsletter, there may be serious gift tax

issues when entering into a split-dollar arrangement similar to that used in the Levine case, which could be viewed as quite negative.

Threshold areas of focus may include: (1) what should someone with an intergenerational split-dollar life insurance plan currently in place do; (2) might planners who have avoided recommending intergenerational split-dollar insurance planning since Morrisette I and II and Cahill have reason to restart intergenerational split-dollar life insurance planning (presumably following the Levine structure exactly as presented); and (3) for permutations of the intergenerational split-dollar life insurance planning for qualified terminal interest property (QTIP) trusts and foreign nongrantor accumulation trusts with large undistributed net income (UNI) balances where §§2036, 2038 and 2703 of the Internal Revenue Code are potentially not relevant, have even more reason to implement intergenerational split-dollar life insurance?

The aforementioned cases fall within the "economic benefit regime." An alternative approach is the "loan regime," which is not discussed in this newsletter.

COMMENT:

What is Intergenerational Split-Dollar Life Insurance?

Before providing a split-dollar insurance planning roadmap based on the Levine case, an explanation of what split-dollar life insurance is may be useful. "Split-dollar" is not a type of life insurance. Rather, it is an arrangement under which the proceeds of a cash value policy are split, divided, or shared at death and, in some cases, may also provide for a splitting of the cost of premiums on the policy. In the family context, split-dollar insurance arrangements are referred to as "private" or "family" split-dollar, in contrast to when the arrangement is used for a key employee (or for a shareholder).[iii] In a private or family split-dollar insurance plan is when two trusts or persons purchase insurance on the life of a particular family member. Typically, when split-dollar is used in an estate plan, an irrevocable life insurance trust ("ILIT") is the owner of the policy. The premiums for the policy involved are often paid by the taxpayer or a proxy for the taxpayer. In the Levine case, the payor of the premiums was a revocable trust established by Mrs. Levine. A similar structure was used in a prior case, Estate of Cahill (which seems to have resulted in a "defeat" for the taxpayer).

The parties to the split-dollar arrangement can agree to allocate policy costs and benefits between them in a variety of ways. For example, in the Levine case, Mrs. Levine's revocable trust advanced the funds for her life insurance trust to purchase policies on her children's lives. And the insurance trust had to pay the revocable trust back an amount equal to the greater of premiums paid, or the cash surrender value of the policies on the earlier the insured's death or the termination of the split-dollar arrangement. Key to the holding in Levine is that Mrs. Levin had no influence whatsoever over the termination of the split-dollar agreement.

There are two types of split-dollar arrangements: (1) the economic benefit regime under Reg. Sec. 1.61-22; and (2) the loan regime under Reg. Sec. 1.7872-15. The prior cases in which the taxpayers lost, Cahill and Morrissette, as well as the current Levine case in which the taxpayer seems victorious, only deal with economic benefit split-dollar.

In these types of economic benefit split-dollar arrangements, the irrevocable life insurance trust ("ILIT") generally pays only for the term cost of the life insurance which is not material in the early years of the arrangement. Another party, such as a family member (often the insureds) or a family trust (e.g., an existing funded marital (QTIP) or dynasty trust) pays the remaining portion, which is generally a significant portion of the insurance cost in the early years of the arrangement. In the Levine case, Mrs. Levine's revocable trust advanced premiums to her insurance trust. This arrangement can potentially accomplish several estate planning goals:

1. It may reduce the current gifts the donor/insured is required to make to the ILIT to purchase the desired life insurance. Absent a split-dollar arrangement or an existing well-funded irrevocable trust, the insured would have to make large dollar gifts to the ILIT to support the purchase of a large life insurance policy. If those gifts would exceed annual exclusions and remaining exemption (or if the taxpayer wishes to preserve those attributes for other planning) then a simple gift structure used for smaller insurance plans will not suffice. If instead, as in the Levine case, the taxpayer, her revocable trust or another trust advance funds pursuant to an economic benefit split-dollar arrangement, then the transfers do not constitute gifts. That avoids the gift tax implications of the typical ILIT funding. That is what was done in the Levine case.

2. Having an ILIT own the policies involved, and assuring that the taxpayer/donor has no incidence of ownership over those policies, may assure that the insurance proceeds are excluded from the donor/insured's taxable estate. In the Levine case several points should be noted. First, Mrs. Levine, as is common in an intergenerational split-dollar plan, was not the insured. Children were the insureds under the policies involved. Further, the policies were purchased from inception by the ILIT and Mrs. Levine never possessed any incidence of ownership in them.
3. The value of the receivable due to the taxpayer (which as stated above is equal to the greater of premiums paid or the cash value of the policy), or in the Levine case Mrs. Levine's revocable trust, might be valued at substantially less than the face value of the monies advanced to the insurance trust. The $6.5 million advance in the Levine case was valued at about a third of that amount as of the time of her death, resulting in Mrs. Levine's estate eliminating approximately 2/3rds of that value from her taxable estate. That seems to have been a substantial savings. This result was also dependent on the Levine Court agreeing that Mrs. Levine had no incidence of ownership over the polices, and no legal right to accelerate the termination of the split-dollar agreement. She in fact did not, and the Levine Court acknowledged that in its holding.

What is an Inter-generational Split-Dollar ("IGSD") Arrangement?

In an inter-generational split-dollar arrangement the follow facts are typically found:

1. The person funding the insurance purchase is usually of advanced age, example 80+.
2. The person funding the life insurance may, but does not always, borrow the money from a lender.
3. The insurance policy is paid for with a single premium or premiums paid over a brief period, e.g., several years as contrasted to a more typical longer period.
4. The insured is an adult child of the person advancing funds for the policy. The adult child or children are typically middle age, e.g., 40-60.
5. The person advancing the funds, e.g., Mrs. Levine, often dies within a relatively brief period of time after the split dollar plan is created. The estate of the person advancing the funds values the interest in

the IGSD at a substantial discount from its face value, using a discounted cash flow analysis taking into account the probability of the insured dying in each year, the proceeds that would be paid in each year and the cash value for each year. The rationale for a significant discount is that the donor's estate is entitled to its repayment when the insured child dies years in the future, and therefore the present value of that repayment may be significantly less than what might ultimately be paid to the estate.

With this background, the remainder of this article will evaluate what Mrs. Levine's plan did correctly and make suggestions for how a taxpayer, with the guidance of a skilled estate planning team, might evaluate such a plan (which will continue to have significant risks and tax issues despite the recent Levine case). Also, whenever appropriate, generalizations from the Levine Court's comments as to estate planning generally, will be offered.

The IRS Challenge of the Plan

The IRS challenged the plan from various perspectives (e.g., the fiduciary relationships, as discussed below). But three key challenges were based on three different Sections of the Internal Revenue Code:

- Inclusion of the entire cash value as of the death of the person advancing the funds for premium payments under Sections 2036
- Inclusion of the entire cash value as of the death of the person advancing the funds for premium payments under Section 2038.
- Disregard pursuant to Section 2703 of the "restrictions" of the split dollar agreement for the advancer of the premiums to access the cash value of the policy

The challenge pertains to the determination of the asset that is included in the taxpayer's estate, and what is the value of the interest under the split-dollar plan that is included. In a split-dollar plan, the taxpayer transfers funds to the ILIT to be used by the ILIT to pay the premium payments in exchange for a repayment right to the taxpayer. The taxpayer, Mrs. Levine (actually her revocable trust but that trust, of course, is included in her estate) will be repaid as is standard under an economic benefit arrangement, the greater of the policy's cash value or funds she advanced.[iv]

Code Section 2036: Code Section 2036(a)(2) can apply to include in the value of the taxpayer's gross estate the value of all property that the

decedent had transferred during lifetime for less than full and adequate consideration in money or money's worth in a bona fide sale or exchange, over which the decedent retained for life the right, alone or in conjunction with another person, to designate the person or persons who shall possess or enjoy the property or the income therefrom.

Code Section 2038: Includes in the gross value of an estate all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale or exchange for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his or her death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3 year period ending on the date of the decedent's death.

As to the above two Code Sections the Levine Court held that it "…*was the Insurance Trust that bought the policies and held them. The Revocable Trust never owned these policies, and there was no "transfer" of these policies from the Revocable Trust to the Insurance Trust… The "property" is also not the receivable itself. That property belonged to the Revocable Trust and now it belongs to the Estate. It was not 'transferred'; it was retained*." The Levine Court concluded that Mrs. Levine did not retain any right to possession or enjoyment of the property transferred. The Tax Court held that, unless Mrs. Levine jointly held the right to terminate the split-dollar life-insurance policy with the irrevocable trust that held the policies, which she did not under the terms of the split-dollar contract, the cash value of the policies held in the insurance trust were not included in her gross estate. The only asset in her estate was her rights under the split-dollar agreement which she could not unilaterally accelerate or terminate.

The IRS argued that Mrs. Levine, through her attorneys-in-fact, stood on both sides of the transactions (the advance and the split-dollar agreement) and therefore could unwind the split-dollar transactions at will. This meant that Mrs. Levine, through the attorneys-in-fact, had the power to surrender the policies at any time for their cash-surrender values. But the court found that this was not the case because an independent trustee owed a

fiduciary duty to beneficiaries, the grandchildren, who were different than the beneficiaries of Mrs. Levine's estate.

Code Section 2703: The IRS argued that the special valuation rules under Code Section 2703 applied to Levine's split-dollar arrangement. Section 2703(a) provides that "…*the value of any property shall be determined without regard to — (1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or (2) any restriction on the right to sell or use such property*."

The IRS argued that when Mrs. Levine, acting through her attorneys-in-fact, entered into the split-dollar arrangement, she placed a restriction on her right to control the $6.5 million in cash and the life- insurance policies. And the restriction on Mrs. Levine's right to unilaterally access the funds transferred to the insurance companies for the benefit of the Insurance Trust is what should be disregarded when determining the value of the property under Code Section 2703(a)(2). Mrs. Levine's estate, however, argued that Code Section 2703 applies only to property owned by a decedent at the time of her death, not to property she had disposed of before, or property like the insurance policies that she never owned at all. The Levine Court agreed.

Levine Planning Roadmap - General Comments

Point #1: Be Meticulous in Attention to Detail: The Levine court recounted in detail the sophistication of the family, the attention to details in all matters not only estate planning, the legitimate and substantial business operations and investments involved (not merely a passive securities portfolio as in bad fact cases that taxpayers lost), etc. This care and diligence seemed to impress the Levine Court and appears to have given legitimacy and respect to the overall plan. This was significant and is not what occurs in estate plans.

The Levine court noted "…*estate planners as skilled as the ones the family retained..."* The Levine Court seems impressed throughout the opinion with the professionalism of how matters were handled. Perhaps, this is an indication of how important doing the opposite of what was done in so many bad fact cases are to succeeding in a challenge. Be thorough, adhere to formalities, etc.

Point #2: Deliberate Careful Planning: The Levine Court stated: "*Swanson [the estate planning attorney] spent a good deal of time thinking through all the advantages and disadvantages, conditions and qualifiers. He put together a PowerPoint presentation for the family in late 2007 or early 2008. Then in January 2008 he sent a letter to Larson and the children in which he described the transaction and its legal and tax implications*." Deliberate careful planning, well explained to the taxpayer, is what advisers should strive for and what taxpayers should demand. Too often this degree of care does not happen, primarily in cases because taxpayers often just do not wish to incur the additional fees to permit their team of professional advisers to operate in this manner. Perhaps this is all a caution to such taxpayers that being "penny wise and pound foolish" is not the way to handle tax planning, especially complex large dollar planning. Taxpayers should very carefully consider the tone and comments in the Levine case to help them understand why deliberate, documented, and thoughtful planning is worthwhile. This type of well documented planning may also help assure that the taxpayer understands the planning. That is worthwhile in every plan. Especially in light of several recent malpractice cases in which the taxpayers claimed that the practitioner did not explain key aspects of the plan to them.

Point # 3: Plan in Advance: In the Levine case, not a great amount of time passed from the implementation of the plan to Mrs. Levine's death. While that was not cited as a "negative" factor by the Levine Court, it is sensible to plan as far in advance as possible. In Levine, the plan was implemented by Mrs. Levine's agents and trustees in June and July 2008, and on January 22, 2009, she died.

In the Cahill case at the time the plan was implemented the 90-year-old father could not manage his own affairs.[v] Like Powell and other cases which were characterized by commentators as "bad fact" cases where the planning was done by the child/heir after the parent/benefactor was not competent. The Cahill policies were purchased in 2010. The donor/taxpayer, Mr. Cahill, who was not the insured, died in 2011. Levine seems to be a taxpayer victory while Cahill appears to be a taxpayer defeat, but how different is Levine then Cahill (or Powell) in this regard? That is why caution is in order and if feasible, efforts to improve the facts beyond that in Levine might be taken.

Levine Planning Roadmap - Comments as to Taxpayer/Decedent

Point #4: Financial Security for Taxpayer: The Levine Court noted: "*From the beginning, Larson [trustee, agent and family advisor and partner] and Levine's children made it clear to Swanson [the estate planning attorney] that Levine wanted enough money to maintain her lifestyle until her death. This meant that any estate planning needed to be done with Levine's excess capital—i.e., assets that she would not likely need during her lifetime*." Preserving adequate resources for the taxpayer engaging in planning is important to deflect a challenge of, for example, an implied agreement with the trustee of a trust, etc. Here, the taxpayers considered and apparently addressed this important consideration. In too many plans, the taxpayers do not have advisers analyze (e.g., prepare forecasts) corroborating their financial position or cushion after proposed transfers are made. In some overly aggressive plans, the focus is only on tax savings and/or asset protection and ignores assuring adequate financial resources to the taxpayer after the transaction. That based on Levine is mistaken. The concept of "excess capital" suitable for transfer discussed in Levine is a concept worth grafting onto planning generally.

Point #5: Decedent Had No Rights: As of the date of her death, Marion Levine, the decedent, possessed only a receivable created by the split-dollar arrangements. This was only the right to receive the greater of premiums paid or the cash surrender values of the policies, when the insurance policies paid off, or when the split-dollar arrangement was terminated, if earlier. Mrs. Levine had no rights on her death, or at any time prior to her death, in the life insurance policies held by the irrevocable life insurance trust ("ILIT"). She never had any rights to modify or terminate the split-dollar agreement (that power was vested solely in the ILIT investment committee (analogous to an insurance trustee), which was Larson. The decedent did not have any right, whether by herself or in conjunction with anyone else, to terminate the policies because only the ILIT had that right.

Contrast the above facts in the Levine case with the facts in the less successful Cahill case. In Cahill, the split-dollar plan could have been terminated during the insured's lifetime by agreement between Survivor Trust and ILIT. This effectively had the son (who was the primary beneficiary of the plan and the agent and trustee for his father), and his cousin/business partner (as trustee of the ILIT) jointly controlling the decision. The Cahill court viewed this as tantamount to the taxpayer being

on both sides of the transaction. The absence of such factors was a critical difference in the Levine Court reaching a favorable decision.

Levine Planning Roadmap - ILIT Comments

Point #6: Be Careful that Only the ILIT Ever Owns the Insurance: The Levine Court stated: "*We find that the "property" at issue cannot be the life-insurance policies, as these policies have always been owned by the Insurance Trust. The split-dollar transaction was structured so that the $6.5 million was paid by the Revocable Trust in exchange for the split-dollar receivable. It was the Insurance Trust that bought the policies and held them. The Revocable Trust never owned these policies, and there was no "transfer" of these policies from the Revocable Trust to the Insurance Trust*." Thus, in the Levine case, since the insurance trust always held the insurance policies, the IRS' attempt to argue that the decedent, Mrs. Levine, had any interest on those policies failed. Careless preparation or handling of insurance company applications and forms, or inartful drafting of legal documentation, could easily have undermined this result.

Point #7: ILIT Decisions Made by An Independent Person: Larson was the sole member of the investment committee that managed the irrevocable trust. Only Larson, the independent insurance trustee (investment committee) had the right to prematurely terminate the life-insurance policies. These arrangements gave the other two attorneys-in-fact for decedent, Mrs. Levine's two children, no rights to terminate the policies or the split-dollar arrangement. Thus, in the Levine case, Larson and the two children were co-agents for Mrs. Levine, but only Larson alone was vested with life insurance decisions in his fiduciary role on behalf of the life insurance trust (ILIT).

Contrast the above with the facts in the Cahill case. In Cahill, the decedent/decedent's agents had the right to agree, along with an independent trustee of the ILIT, to a termination of the split-dollar agreement. If the agents for the decedent could agree this put the decedent while alive, through his agents, in a position of having a say in the termination of the plan. That was a fatal flaw in the Cahill case. This point was a critical element of the case that supported the taxpayer victory in Levine, although if a similar plan were to be structured in the future, the overlap of Larson serving as the transferor's co-agent and ILIT trustee should be avoided, as discussed below.

However, how different in reality were the facts in Levine from those in Cahill? In Levine, Larson (a family friend, business partner and perhaps an employee/officer of one or more family businesses) was a co-agent and the insurance trustee. Perhaps the points of the successful Levine case might be expanded for future planning to assure greater and more complete independence of the fiduciaries on each side of the transaction. Perhaps to be careful in similar plans (split-dollar or otherwise) if a person is named as agent for the taxpayer under her power of attorney (or as a trustee or successor trustee under her revocable trust) perhaps that person should not be named also in a fiduciary or other position of control over an irrevocable trust that engages in a plan with the taxpayer. Perhaps more care than in the Levine case might be worth planning for.

Point #8: Name Independent Trustees: Larson was under a fiduciary duty to exercise his power to direct the Insurance Trust's investments prudently, and he faced possible liability to its beneficiaries if he breached that duty. Fiduciary duty is a crucial factor in the Court's analysis in Levine. The Insurance director/trustee (in the Levine case the fiduciary acted under the moniker of "Investment Committee") had a fiduciary obligation to the beneficiaries to make reasonable decisions. The Levine Court noted above the independence of the person named (he was not family), and his business and financial acumen enabling him to carry out those fiduciary duties.

But in Cahill, even though the ILIT trustee was a cousin and business partner of the son, he still had a fiduciary responsibility to act appropriately for the beneficiaries of the trust. If that fiduciary responsibility required that he not terminate the split-dollar agreement, then could he be assumed to do so? What quantum of independence might be necessary for that fiduciary responsibility to be relevant? Would the Cahill Court opt to disregard the fiduciary responsibility in all situations? Can it? How different is a cousin/business partner in Cahill versus a 50-year employee/business partner, Larson, who was not a relative in the Levine case? Would a second cousin be viewed differently? How can the facts in the two cases be reconciled to an understandable framework from which to plan?

The safer course of action when planning a new trust or transaction would be to name fiduciaries, if feasible, that are even more independent then Larson was in the Cahill case. The trustee of a trust should not also be the taxpayer's agent under a durable power of attorney (or a trustee under the taxpayer's revocable trust). It would also be preferable that the person

named to be an independent fiduciary is not an employee of the taxpayer's family business. If possible, not being a significant partner of the taxpayer may also be helpful. In short, although the taxpayer was victorious in the Levine case, it might be safer to plan even more carefully, and not merely mimic the planning pattern in the Levine case when structuring a new transaction.

Point #9: Independent Institutional General Trustee: South Dakota Trust Company was named the general trustee of the trust in the Levine case. The use of not just an independent trustee, but an independent institutional trustee, was viewed very favorable by the Court. The cost of naming an institutional administrative trustee (in a directed trust structure) is modest relative to the value of most plans; yet taxpayers resist because of the concerns over avoidable cost. But those taxpayers having doubts should read the Levine case as the Court's opinion provides confirmation that this step may well be worth the cost involved.

Taxpayers prefer the use of family trustees because, not only may they not charge fees, but it is assumed that the family fiduciary will accommodate any request. But the latter point is exactly why using an institutional trustee may infuse more independence, reality, and respect for any transaction. Again, another lesson from the Levine case is to endeavor to use independent institutional trustees when feasible. Perhaps that should be the default approach for some planning.

Point #10: Person Holding Power to Modify Split Dollar Agreement is a Fiduciary: The Levine Court noted: "*The terms of the Insurance Trust expressly state that Larson—in his role as the single-member investment committee—shall be considered to be acting in a fiduciary capacity*…" The Levine Court noted the: "…*fiduciary obligations Larson owes to the beneficiaries of the Insurance Trust—obligations that would prevent him from surrendering the policies*." Be certain the facts comport with that requirement.

Point #11: Trustee Should have Fiduciary Duty to Unique/Different Beneficiary: The fiduciary obligation that Larson had as the Investment Committee in the Levine case was to a distinct/different beneficiary: "*Levine's children are not the only beneficiaries under the Insurance Trust. Her grandchildren are also beneficiaries, and Larson has fiduciary obligations to them as well*." In the Cahill case, in contrast, the

beneficiaries of the insurance trust and Mr. Cahill's estate were the identical.

Point #12: Careful Drafting: Do not Let a Power of Appointment Defeat the Independent Beneficiary: The Court noted: "*The Insurance Trust's beneficiaries were Robert, Nancy, and Levine's grandchildren—the grandchildren that Levine naturally wanted to take care of*." The different/distinct beneficiaries should be persons the decedent wants to benefit and that should be documented. Be certain in drafting the insurance trust (ILIT), or other trusts or documents, that the independent/distinct beneficiary cannot be removed by an exercise of a power of appointment ("POA"). A power of appointment is a right to designated who may benefit from property, e.g., in a trust. So, for example, a child may be given a lifetime power of appointment to designate which persons may benefit from the property. Had the children in Levine held a broad enough lifetime power of appointment so that they could have defeated the grandchildren's rights, the results in the Levine case may have been different. The Levine Court noted this. The Levine Court stated: "*So if Nancy and Larry hoped to extinguish the interests of their own children, they could not do so until they themselves directly named some other beneficiary to take their place. This means that during the lives of Nancy and Robert, their children will remain beneficiaries of the Insurance Trust, and a decision by Larson to surrender the policies would mean the grandchildren would receive nothing. This would breach his fiduciary duties to them*." When crafting a trust plan, be careful that the powers granted under the trust or another instrument, do not defeat the independence (such as different beneficiaries) that are helpful to supporting the integrity of the plan.

Point #13: Be Cautious of An IRS Argument about Fiduciary Similarity: In Levine, the Court Stated: "…*Commissioner makes his thrust. He contends that Levine—through her attorneys-in-fact—stood on both sides of these transactions and therefore could unwind the split-dollar transactions at will. This meant that she—again through the attorneys-in-fact—had the power to surrender the policies at any time for their cash-surrender values*." In Levine there was a similarity in fiduciaries as Larson was an agent under Mrs. Levine's power of attorney, and a trustee (investment committee) of the ILIT. Although the taxpayer succeeded in Levine, a more cautious approach may be worthwhile. If possible, structure the transaction with different and independent fiduciaries on each

side of the plan and transactions. Why not make the agent under the power of attorney/successor trustee under the revocable trust, different than the person named as ILIT trustee (investment committee in this instance)?

Split-Dollar Loan Arrangements

Point 14: Decedent/Revocable Trust Have No Rights under Split-Dollar Documents: The Court stated: "*It was especially important, if this deal was to work, that the Insurance Trust and not the Revocable Trust own the policies. The recitals in the arrangements state that the parties do not intend to convey to Levine or the Revocable Trust any "right, power or duty that is an incident in ownership . . . as such is defined under Section[s] 2035 and 2042…in the life-insurance policies at the time of Levine's death. They also state that neither the Insurance Trust, nor its beneficiaries, nor the insureds— Nancy and Larry—would have access to any current or future interest in the cash value of the insurance policies. We also specifically find that only the Insurance Trust—and that means Larson—had the right to terminate the arrangements*." The Court noted as significant (what some might characterize as self-serving) the statements and contractual restrictions, in the split-dollar legal documentation.

Point 15: Only the ILIT could Terminate the Split Dollar Arrangement: "*The Insurance Trust shall have the sole right to surrender or cancel the Policy during the lifetime of either insured. In addition, the Insurance Trust may terminate this Agreement in a writing delivered to the other party, effective upon the date set forth in such writing*." This was a key fact in the case. However, it is noted that Larson, the Investment Committee (insurance trustee) was a key employee of family business enterprises, but that point and the possible implications to the family controlling Larson's actions do not appear to be discussed in the case.

The above structure was also quite different then in the Cahill case wherein the decedent in conjunction with the trustee of the insurance trust could determine to terminate the arrangement. An essential difference between the results in Cahill and Levine, which was a focal point of the taxpayer favorable decision in Levine, was a line or two in the split-dollar documentation specifying who could terminate the arrangement.

"*The split-dollar arrangements we analyzed in Morrissette II and Estate of Cahill were different. Look at the language in those arrangements. In Morrissette II: The Donor and the Trust may mutually agree to terminate*

this agreement by providing written notice to the Insurer, but in no event shall either the Donor or the Trust possess the unilateral right to terminate this Agreement."

The difference seems quite limited but apparently enough to suffice. In Cahill, the decedent had to agree to the termination but could not unilaterally terminate. In Levine, a long-time employee and business partner alone controlled the decision. Thus, while the taxpayer in Levine was successful, when planning other transactions, it might be advisable, as discussed above, to have a trustee with greater independence (e.g., not a co-agent under the taxpayer's power of attorney, not an employee/partner, etc.).

How important was that? Even though Mrs. Levine and the trustee of the life insurance trust did not expressly retain the right to terminate the arrangement, they certainly could do so by mutual agreement at any time. The Levine court apparently felt that this difference was sufficient citing to Helvering v. Helmholz, 296 U.S. 93 (1935) and Estate of Tully v. U.S., 528 F.2d 1401 (Ct. Cl. 1976),

Point #16: Watch the Precise Language in the Split-Dollar Contract Documents: The Levine Court noted: "…*general default rules of contract—rules that might theoretically allow modification of just about any contract in ways that would benefit the IRS—are not what's meant in phrases like section 2036's "right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom," or section 2038's "power . . . by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power)." What is meant are rights or powers created by specific instruments*."

This is the crux of the Court's reasoning in Levine that deflects the IRS challenge under Code Sections 2036 and 2038 that Mrs. Levine had retained inappropriate rights or interests in the assets transferred from her estate. The split dollar agreement expressly gave the right to the ILIT trustee to make the decision and that is a key difference between the documentation in Cahill and Levine.

Especially in a state with "modern trust laws," practitioners are advised to consider whether a non-administrative trustee or advisor might have a not

so obvious power to impact the contract documents to vitiate the Levine approach which supported the favorable Court conclusion.

Premium Financing Considerations

Point #17: Premium Financing Should Be Long Term and the Cost Less than the Return on the Policies: Is this even possible? The term of the longest loan in the Levine case was 60 months. Compare this to the Cahill case which was viewed as a victory for the IRS. In Cahill, the transaction may not have been economically viable for the long term because the loan term was for five years. The lender in Cahill, also an independent institution, Northern Trust, did not have to renew the loan. There is no indication in Levine that any lender had to renew loans.

In Cahill, the loan interest rate may have exceeded the guaranteed rate of return on the policy cash value. That factor does not appear to be analyzed in Levine. Then why was the transaction in Levine viewed so much more favorably than the transaction in Cahill? Might longer term loans or loans with an indication of they can be renewed be safer?

Valuation Considerations

Point #18: Do not be a Valuation Pig: In Levine, the Insurance Trust had promised to pay the Revocable Trust the greater of $6.5 million or the policies' cash surrender value at either the death of both Nancy and her husband or upon termination of the policies. At the time of Levine's death, this value was close to $6.2 million, but the value of the Revocable Trust's interests was determined to be $2.1 million.

Contrast the above valuation reduction in Levine to that reduction claimed in Cahill. In Cahill $10 million was transferred to the insurance trust. The Cahill estate claimed the discounted value of the future repayment was $183,700, which is 1.9% of the cash value. The discount sought by the taxpayer in Cahill was dramatically larger than the relative discount sought in the Levine case. Was the excessive nature of the discount in Cahill part of the reason for the Court's reaction? But how much of a discount is then "reasonable" before incurring the Court's wrath?

Rational Purpose for Insurance and Plan

Point #19: Insurance on Lives of Children Made Sense: The attorney for the decedent identified the "…*children's situation and learned that they themselves also had large real-estate holdings and completely lacked any*

estate plans. So, he suggested to them and Larson that there just might be a way for Levine to invest her excess capital to provide her with a good return, while at the same time meshing with the Levine children's needs for estate plans of their own…who themselves have a sufficient net worth to qualify for large life-insurance policies."

In Footnote 11: the Court said: "…*we find him [Swanson the attorney] credible when he said that he also viewed the Insurance Trust as something Nancy and Robert [the children] could use in their own eventual estate planning*."

This suggests that there was a logical reason to have life insurance on the children's life. Contrast this with the facts in other cases where the purpose of the life insurance may have been viewed as providing a tax savings primarily or even only.

Point #20: Have and Corroborate a Business Purpose: The Levine Court noted: "*In the Commissioner's view, this entire transaction was merely a scheme to reduce Levine's potential estate-tax liability and, if it was a sale, it was not bona fide because it lacked any legitimate business purpose*."

Although the taxpayer succeeded to demonstrate a non-tax purpose for the transactions in the Levine case, practitioners should endeavor in planning they implement to corroborate and document a business purpose and that the plan is not a scheme.

What Might Be Next?

So, should the IRS just put its tail between its legs and whine about the Levine case pro-taxpayer results? Well, the Tax Court in Levine seems to have given the IRS a suggestion: amend the split-dollar regulations for estate tax purposes. It is not certain what the Treasury would do in that regard. There is also another route for the Service, perhaps, to consider: contend there was a significant gift when the split-dollar arrangement was initiated.

As indicated above, split-dollar plans originally were between employers and employees with the IRS contending that the employee received each year the plan was in place an *annual* economic benefit equal to the value of the amount of insurance protection the employee controlled. That makes sense because, even if the split-dollar arrangement is contract between employer and employee, it would end when the employee leaves

employment which could occur in any year. But in a typical family split-dollar arrangement, the advancer of premiums is making a promise to pay premiums each year. So, the benefit to the other party (e.g., the ILIT in Mrs. Levine's case) is all made upfront, not annually. Hence, the IRS perhaps should have argued that Mrs. Levine made a gift of up to $6.5 million when the split-dollar arrangement was inked.

One more point. Although some split-dollar arrangements have been entered into with QTIP trusts, it is possible the IRS will contend that the arrangement triggers Code Sec. 2044 (causing the entire QTIP to be subject to gift tax) where a gift is deemed made by the spouse who is the beneficiary of the QTIP because the transfer of the premiums in the year the split-dollar arrangement is made (or the promise to do so over years but constituting a transfer again when the split-dollar arrangement is entered into) was for less than full and adequate consideration because, as the Levine case demonstrates, the advancer of the premium funds was going to get back much less in terms of current value.

Hence, in dealing with economic benefit split-dollar, as Sergeant Esterhaus said in Hill Street Blues, "Let's Be Careful Out There."

HOPE THIS HELPS YOU HELP OTHERS MAKE
A *POSITIVE* DIFFERENCE!

Martin M. Shenkman

Jonathan G. Blattmachr

Lawrence Lipoff

CITE AS:

CITATIONS:

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[i] Estate of Marion Levine v. Comr., 158 T.C. -- No. 2, February 28, 2022.

[ii] Estate of Morrissette v. Commissioner, T.C. Memo 2021-60 (May 13, 2021) put the kibosh on a complex insurance tax plan and handed the IRS a victory. The case has been nicknamed in the tax planning community as "Morrissette II" since it follows a case for the same taxpayer, Estate of Morrissette v. Commissioner, 146 T.C. 171 (2016) (which we can now call Morrisette I). For an analysis of Morrisette see: Gans & Shenkman "Morrissette II: Why the Tax Court May Have Improperly Applied the Hypothetical Purchaser Framework," LISI Estate Planning Newsletter #2896 (July 19, 2021) at www.leimbergservices.com.

[iii] See, e.g., PLR 9636033 (not precedent).

[iv] See Rev Rul 64-328.

[v] Cahill v. Comr.. 115 T.C.M. (CCH) 1463 (2018).